Cite as: *Size Appeal of EA Engineering, Science, and Technology, Inc.*, SBA No. SIZ-4973 (2008)

# United States Small Business Administration
# Office of Hearings and Appeals

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| SIZE APPEAL OF:<br><br>EA Engineering, Science, and Technology, Inc.<br><br>Appellant<br><br>Appealed from<br>Size Determination No. 02-2008-49 | SBA No. SIZ-4973<br><br>Decided: July 14, 2008 |

## APPEARANCES

Richard P. Rector, Esq., Seamus Curley, Esq., and Eric M. O'Neill, Esq., DLA Piper US LLP, Washington, D.C., for Appellant.

Traeger Machetanz, Esq., Oles Morrison Rinker & Baker LLP, Seattle, Washington, for FPM Group, Ltd.

## DECISION

PENDER, Administrative Judge:

### I. Introduction and Jurisdiction

This appeal arises from a May 20, 2008 size determination (Case No. 02-2008-49) finding EA Engineering, Science, and Technology, Inc. (Appellant) to be other than a small business for a 500 employee size standard. The size determination arose from a February 6, 2008 protest filed by FPM Group, Ltd (FPM), an unsuccessful offeror. For the reasons discussed below, I reverse the size determination.

The Small Business Administration (SBA) Office of Hearings and Appeals (OHA) decides size appeals under the Small Business Act of 1958, 15 U.S.C. § 631 *et seq.*, and 13 C.F.R. Parts 121 and 134. Accordingly, this matter is properly before OHA for decision.

### II. Issues

1. Whether a protest is timely if received 98 days after the Contracting Officer (CO) informed the protester that Appellant was selected for negotiation of an Architect/Engineer contract.

2. Whether a Stockholder Agreement's supermajority requirements for transactions outside the ordinary course of business provide a large concern with the negative power to control a small concern under 13 C.F.R. § 121.103(a)(3).

## III. Background

### A. Findings of Fact

1. On April 18, 2007, the Air Force Center for Environmental Excellence (Air Force) issued Solicitation No. FA8903-07-R-8325 (RFP) for multiple awards of indefinite delivery/indefinite quantity (IDIQ) contracts covering a host of Architect/Engineer services. The Air Force sought to award approximately twenty to twenty-five IDIQ contracts, fifteen of which were to be awarded under full and open competition. The Air Force intended to reserve award of the remaining contracts under 8(a), service-disabled veteran-owned small business, or competitive small business set-aside procedures. The CO designated North American Industry Classification System (NAICS) code 562910, Environmental Remediation Services, with a 500 employee size standard for the small business set-aside portion of the RFP. Proposals were due on June 4, 2007.

2. On September 18, 2007, the CO informed Appellant that it been selected for negotiation of an IDIQ Architect/Engineer contract arising out of the small business set-aside portion of the RFP. On October 31, 2007, the Contracting Officer informed *all* offerors of the firms, including Appellant, selected for negotiation under the small business set-aside portion of the RFP in accordance with (IAW) FAR 36.606.

3. On January 30, 2008, the Air Force notified offerors that Appellant was one of the apparent successful offerors on the small business set-aside portion of the procurement. The Air Force stated that all size protests must be received by the CO no later than February 6, 2008.

4. On February 6, 2008, FPM protested Appellant's size. FPM alleged that (1) the Louis Berger Group, Inc. (LBG), an other than small concern, exercises negative control over Appellant; (2) Appellant and LBG share an economic identity of interest; and (3) the totality of the circumstances warrant a finding of affiliation between LBG and Appellant.

5. On February 7, 2008, the Contracting Officer (CO) forwarded FPM's protest to the SBA Office of Government Contracting, Area II, in Philadelphia, Pennsylvania (Area Office) for a size determination.

6. On February 12, 2008, the Area Office notified Appellant of the size protest and requested it submit its SBA Form 355, a response to the allegations in the protest, and other organizational and financial information within three working days.

7. On February 25, 2008, Appellant responded to the size protest. Appellant asserted that FPM's protest should be dismissed as untimely because FPM received notice "of the 'final slate' of firms selected for negotiation" on October 31, 2007. Appellant also responded

substantively to the protest and refuted FPM's protest allegations. Appellant also set forth a detailed description of the company, its history and bylaws, and its relationship with LBG, an admitted other than small concern.

8. In responding to the protest, Appellant explained that it is a highly specialized small business with significant experience and expertise in environmental remediation. Further, Appellant aggressively competes for federal, state, local, and commercial contracts against LBG. Appellant also asserted that it has derived only 1.95 percent of its revenue from relationships with LBG over the past six fiscal years.

9. Appellant also supplied its April 28, 2005 Stockholders' Agreement (Stockholder Agreement) among Appellant, Appellant's Employee Stock Ownership Plan (ESOP) Trust, and Louis Berger Holdings, Inc. Among the recitals was the intent of the parties that Appellant retain its classification as a small business concern by SBA. The critical part of the Stockholder Agreement is as follows:

> Voting and Board Composition
>
> 8.1 Action Requiring Stockholder Approval.
>
> 8.1.1. Super-Majority Voting. Except upon the affirmative vote of Stockholders holding at least sixty-seven percent (67%) of the issued and outstanding Shares, [Appellant] shall not take any of the following actions:
>
> 8.1.1.1. amend, repeal or change, directly or indirectly, any of the provisions of [Appellant's] Certificate of Incorporation, as amended (the "Charter"), or the Bylaws of [Appellant], as amended (the "Bylaws");
>
> 8.1.1.2. issue additional shares of capital stock of [Appellant]; or
>
> 8.1.1.3. enter into any business substantially different from the business engaged in by the Company as of the date of this Agreement.

10. LBG owns 49.5 percent of Appellant's stock. Appellant's ESOP owns 45.8 percent of Appellant's stock, and the remaining 4.7 percent of Appellant's stock is owned by various Management Stockholders who, according to the Stockholder Agreement § 8.2.1, must vote their shares in accordance with the ESOP. Combined, the ESOP shares and the Management shares (50.5 percent of the total) are known as the ESOP block.

11. Appellant's Board of Directors is limited to five (5) individuals, three (3) of which are elected by the ESOP block. LBG has the right to elect the other two directors. Directors independently elected by the ESOP block (not subject to approval by LBG) constitute a quorum of the Board of Directors under Appellant's Bylaws. There is nothing in the Stockholder Agreement limiting the ESOP-elected Directors' right to establish compensation, hire and fire any corporate officer, borrow money, dispose of assets, pursue business consistent with its history, or otherwise act in Appellant's best interest. Nor is there any requirement for

supermajority approval for any action not reserved in paragraph 8.1.1 of the Stockholder Agreement.

12. There is no evidence that LBG is involved in any capacity with the instant procurement.

B. The Size Determination

On May 20, 2008, the Area Office issued its size determination finding Appellant other than small based on its affiliation with LBG, an other than small concern.

First, the Area Office addressed the issue of the timeliness of the protest. The Area Office found the protest timely based on the CO's January 30, 2008 letter. The Area Office noted, however, that even if the protest were untimely, the Area Director would have initiated his own size protest under 13 C.F.R. § 121.1001.

The Area Office also found the following general facts to be true:

1. The Bylaws reflect standard quorum requirements where only a majority of the stockholders or Board of Directors are required for day-to-day operational issues or to hold an annual meeting;

2. The Bylaws reflect that the presence of LBG is not required to establish a quorum for stockholder or Board of Director meetings that pertain to the day-to-day operational issues or to hold an annual meeting;

3. LBG, as a single entity, is Appellant's largest stockholder;

4. There is no evidence that LBG is involved in any capacity with the instant procurement or is Appellant's subcontractor for the instant procurement;

5. There is no evidence that any of Appellant's officers or directors are involved with or employed by LBG;

6. Appellant, as a single entity, employs less than 500 employees;

7. LBG is an other than small concern (under the applicable NAICS code) that is engaged in engineering, environmental sciences, and other economic development operations;

8. The Stockholders' Agreement among LBG, the ESOP, and the Management Stockholders was executed on April 28, 2005 and supersedes all previous agreements;

Next, the Area Office examined the merits of the protest and concluded that Appellant

and LBG were not affiliated through stock ownership,[1] 13 C.F.R. § 121.103(c), because the ESOP block controls Appellant based on the combined 50.5 percent stock ownership of the ESOP (45.8 percent) and the Management Stockholders (4.7 percent). The Area Office combined the ESOP and Management Stockholders' ownership because they "share a common interest in sustaining" Appellant. Size Determination, at 6.

The Area Office found, however, that the ESOP block's control was limited by Appellant's Stockholder Agreement, which required the affirmative vote of stockholders owning 67 percent of the issued and outstanding shares in order to amend Appellant's charter or bylaws, issue additional shares of stock, or enter into a substantially different business. Therefore, the Area Office found that LBG's 49.5 percent stock ownership resulted in LBG having the negative power to block certain transactions outside of the ordinary course of business and thus LBG had the negative power to control Appellant and was its affiliate under 13 C.F.R. § 121.103(a)(3).

Next, the Area Office found Appellant affiliated with LBG based on an identity of interest, 13 C.F.R. § 121.103(f). The Area Office acknowledged that Appellant does not depend on LBG for revenue, but nonetheless found that Appellant was financially dependent upon LBG and thus shared an identity of interest. Specifically, the Area Office found (1) LBG owns the largest single block of stock in Appellant; (2) LBG can exert negative control over Appellant, affecting Appellant's stock value; and (3) LBG could divest its 49.5 percent ownership in Appellant, which "would have a significant impact on [Appellant's] financial condition." Size Determination, at 8.

Finally, in light of the above, the Area Office found it unnecessary to determine affiliation based on the totality of the circumstances.

C. The Appeal

On June 4, 2008, Appellant filed the instant appeal. Appellant first reiterates its concern that FPM's protest was untimely filed based on the CO's October 31, 2007 letter notifying all offerors of the final slate of firms selected for negotiations. Appellant also notes that while the Area Director stated that he "would have" exercised his authority to initiate his own size protest under 13 C.F.R. § 121.1001(a)(1)(iii), he did not file his own size protest.

Appellant then asserts that LBG cannot control Appellant through stock ownership because (1) LBG does not own or have the power to control 50 percent or more of Appellant's voting stock or a block of voting stock that is large compared to other outstanding blocks; (2) LBG's 49.5 percent stock ownership is not large when compared to the ESOP block's 50.5 percent ownership; and (3) LBG's stock ownership is not large even compared to the ESOP's 45.8 percent ownership. Further, the Area Office concluded that the ESOP block exerts actual control over Appellant.

[1] While the Area Office found there was "affiliation between [Appellant] and LBG through stock ownership," the Area Office relied not upon the requirements of 13 C.F.R. § 121.103(c), but the effect of LBG's stock ownership on its power to assert negative control under 13 C.F.R. § 121.103(a)(3).

Appellant then argues that LBG cannot exert negative control over Appellant because LBG can neither prevent a quorum of stockholders nor block any action of the ESOP block. Appellant asserts it does not have any LBG executive officers nor may LBG appoint or discharge any directors appointed by the ESOP block. Appellant also contends that all day-to-day business decisions require all non-LBG shares to be voted as a single block, preventing LBG from exerting control over Appellant.

Next, Appellant argues that the requirement for a supermajority on fundamental changes does not endow LBG with the power of negative control over Appellant. Appellant distinguishes the cases relied upon by the Area Office and argues the decisions do not stand for the proposition that any supermajority voting requirement creates negative control or affiliation through stock ownership. Instead, the caselaw supports the proposition that supermajority requirements may be inappropriate if they limit the small firm's ability to manage and control day-to-day business operations, and not the fundamental changes set forth in Appellant's Stockholder Agreement.

Appellant maintains that the Area Office's determination creates a *de facto* prohibition on any supermajority voting requirements, which would cause passive investors to have no defense against fundamental changes to the small business in which they invest. Appellant argues this prohibition would have a chilling effect on a small business's access to capital. Appellant argues that no such prohibition exists in the regulations and further other SBA programs contemplate supermajority requirements and conclude they are not a proper basis for finding negative control. Specifically, the service-disabled veteran-owned small business regulations allow supermajority provisions so long as the protected ownership class controls the Board of Directors. *See* 13 C.F.R. § 125.10(e). Appellant asserts the Area Office acknowledged that the ESOP block controls its Board and erred as a matter of law by concluding that negative control existed based on the narrowly tailored supermajority provisions.

Appellant then argues that it does not share an economic identity of interest with LBG. In fiscal year 2007, Appellant asserts that 2.48 percent of its agreements involved LBG and over the past six fiscal years, only 1.95 percent of Appellant's annual revenue, on average, involved LBG. Thus, Appellant does not depend upon LBG for a high percentage of its revenue, which is in line with OHA's caselaw. Appellant asserts that the Area Office acknowledged that Appellant does not depend upon LBG for its revenues, yet inexplicably determined there was nonetheless an identity of interest based on the fact that Appellant would be significantly impacted if LBG sold its interest in Appellant. Appellant asserts the Area Office's cited authority, *Size Appeal of Faison Office Products, LLC*, SBA No. SIZ-4834 (2007) (*Faison*), does not support this conclusion.

Instead, Appellant asserts the factors cited in *Faison* support its position that Appellant is not dependent upon LBG. First, LBG has no control or veto power over management decisions such as strategic planning, budget approval, or the employment or compensation of officers. Second, LBG cannot control the Board of Directors and is not part of a controlling voting stock. Third, while Appellant and LBG are in similar lines of business (although LBG engages in a wide variety of businesses), Appellant and LBG "compete vigorously, and often blindly, against each other in the limited area where their businesses overlap." Appeal, at 29. Finally, any

dealings between Appellant and LBG are at arms-length and the companies are not co-located.

Appellant also argues the Area Office misapplies logic by contending LBG's hypothetical divestiture in Appellant supports a finding of an economic identity of interest. First, Appellant argues such an identity of interest finding should be supported by facts showing the firms' interests are aligned, not based on a hypothetical adverse action. Second, Appellant is not public, so LBG's divestiture would not impact Appellant's stock price. Moreover, Appellant's organizational documents do not grant LBG the right to force Appellant to purchase LBG's shares if LBG sells its interest. Thus, any divestiture by LBG would not require Appellant to come out of pocket or otherwise obtain financing. Appellant does, however, have the opportunity to buy back LBG's shares if financially advantageous. Finally, the Area Office failed to evaluate the fact that Appellant can rebut any identity of interest finding by showing its independence from LBG. Specifically, Appellant derives marginal revenues from LBG (less than two percent), LBG is not involved in any capacity in the instant procurement, and Appellant competes with LBG. Moreover, Appellant's Bylaws reflect standard quorum requirements and do not provide for supermajority provisions for day-to-day operational issues.

### D. FPM's Response

On June 19, 2008, FPM responded to Appellant's Appeal Petition. FPM asserts the Area Office correctly interpreted OHA caselaw to support its finding that LBG exercises negative control over, and is thus affiliated with, Appellant based on its ability to exert negative control over decisions that are outside the ordinary course of business. FPM refutes Appellant's contention that negative control must extend to day-to-day operations in order to find the companies affiliated. FPM also argues that if OHA disagrees with the Area Office's bases for affiliation, OHA may find LBG and Appellant affiliated based on the totality of the circumstances.

### E. Protective Order

At Appellant's request, on June 9, 2008, I issued a Protective Order in this matter due to the potentially confidential and proprietary information contained in the Record. On June 17, 2007, I admitted FPM's counsel under the Protective Order.

## IV. Discussion

### A. Timeliness

Appellant filed its appeal within 15 days of receiving the size determination. Thus, the appeal is timely. 13 C.F.R. § 134.304(a)(1). The issue of the timeliness of FPM's underlying protest is a separate issue.

Under 13 C.F.R. § 121.1004(a)(2), size protests of negotiated procurements must be received by the contracting officer before close of business on the fifth day, not including weekends and holidays, after the contracting officer has notified the protestor of the identity of the prospective awardee. The instant procurement is a negotiated procurement for

Architect/Engineer Services under FAR Subpart 36.6. This is important, for Architect/Engineer Services selection procedures are different than most other procurements. For example, selection is made on the basis of technical qualifications and price discussions do not occur until the selection authority selects a firm for negotiation. *See* FAR 36.602 and 36.606. Following selection for negotiation, the contracting officer negotiates price with the most preferred firm in the final selection (FAR 36.606), and ultimately awards the contract.

While SBA's regulations do not specifically address the timeliness of protests involving Architect/Engineer Services, I hold when an Architect/Engineer firm is selected for negotiation IAW FAR 36.606, the five day protest period in 13 C.F.R. § 121.1004(a)(2) is triggered. Therefore, I find the CO's October 31, 2007 notification to all offerors that Appellant had been selected for negotiation under the small business set-aside portion of the RFP (Fact 2), constituted the CO's notice that Appellant was a prospective awardee under 13 C.F.R. § 121.1004(a)(2). Hence, I find the CO's letter of January 30, 2008 (Fact 3), which purported to trigger the five day protest requirement, has no consequence. The CO made FPM and other unsuccessful offerors aware that Appellant was a prospective awardee on October 31, 2007; therefore, FPM's protest was untimely.

In the size determination, however, the Area Director stated that he would have made his own protest under 13 C.F.R. § 121.1001(a)(1)(iii), if he considered FPM's protest untimely. Based upon the Area Director's unequivocal statement, I find he adopted FPM's protest. Therefore, despite FPM's untimely protest, I will not vacate the size determination because time limits do not apply to protests filed by contracting officers or the SBA. 13 C.F.R. § 121.1004(b).

## B. Standard of Review

The standard of review for this appeal is whether the Area Office based its size determination upon clear error of fact or law. 13 C.F.R. § 134.314. In evaluating whether there is a clear error of fact or law, OHA does not consider Appellant's size *de novo*. Rather, OHA reviews the record to determine whether the Area Office based its size determination upon a clear error of fact or law. *See Size Appeal of Taylor Consultants, Inc.*, SBA No. SIZ-4775 (2006), for a full discussion of the clear error standard of review. Consequently, I will disturb the Area Office's size determination only if I have a definite and firm conviction the Area Office made key findings of law or fact that are mistaken.

## C. The Merits

At the outset, it is important to emphasize that the facts are not in dispute but rather the Area Office's application of the applicable size regulations to the facts.

### Affiliation based on Negative Control

SBA's affiliation regulation provides:

> Control may be affirmative or negative. Negative control includes, but is not limited to, instances where a minority shareholder has the ability, under the

> concern's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.

13 C.F.R. § 121.103(a)(3).

First, the instances of negative control cited in 13 C.F.R. § 121.103(a)(3) are inapplicable here because LBG can neither prevent a quorum nor block *ordinary* actions by the board of directors or shareholders. The issue on appeal is whether the Stockholder Agreement's supermajority requirements for transactions outside the ordinary course of business provide LBG with the negative power to control Appellant.

The text of 13 C.F.R. § 121.103(a)(3) does not provide detailed guidance about what constitutes negative control, other than mentioning that preventing a quorum or having the ability to block action by the board of directors and shareholders is relevant. Thus, identification of the kind of power that constitutes negative control has been the subject of development over many years by OHA.

The Area Office relied on *Size Appeal of Dependable Courier Services, Inc.*, SBA No. SIZ-2110 (1985) (*Dependable*). In *Dependable*, OHA held there was affiliation when a stock purchase agreement restricted the small concern's ability, without the consent of the large concern, to: (1) alienate or encumber its assets; (2) amend or terminate existing lease agreements; (3) purchase equipment; (4) increase employee compensation; and (5) incur debts or obligations without consent.

Even though the controls OHA addressed in *Dependable* are characterized as limited to scenarios outside the normal course of business, the negative controls are extensive and present a scenario where the small concern is not free to conduct business as it chooses. Here, the facts are distinguishable. Unlike *Dependable*, Appellant can borrow (incur debt) for any reason, increase employee compensation, purchase equipment, amend or terminate lease agreements as it sees fit, or alienate or otherwise encumber any asset for any reason (Fact 11). Moreover, the supermajority requirements in Appellant's Shareholder Agreement pertain to events that have nothing to do with management decisions that affect Appellant's daily operations. Instead, the controls pertain to protecting LBG's ownership stake in only three extraordinary circumstances (Fact 9).

The Area Office also cited *Size Appeal of Jensco Marine, Inc.*, SBA No. SIZ-4330 (1998) (*Jensco*), in support of its size determination. In *Jensco*, however, OHA found affiliation because the large concern had the ability to prevent a quorum at both shareholders' meetings and prevent a quorum of Board of Directors deciding any type of action (ordinary and major). The discussion in *Jensco* is over-inclusive, *i.e.*, it addresses power to control both ordinary and "major actions." Therefore, it is not clear whether the negative power to control extraordinary actions alone (the issue in the instant case) would have been sufficient to prove affiliation. Thus, I do not find *Jensco* controlling.

After considering *Dependable* and *Jensco*, I examined the other cases cited in the size determination and found none of them relevant. I also failed to find other OHA cases involving

negative control with facts parallel to the supermajority requirements in Appellant's Stockholder Agreement. Instead, I found cases where the negative power to control affected the small concern's ability to manage and operate its business. *See, e.g.*, *Size Appeal of Sterling Foods, Ltd.*, SBA No. SIZ-4556 (2003). The supermajority provisions here cannot affect Appellant's operations. Rather, these supermajority provisions are crafted to protect LBG's investment and not to interfere with the ESOP block's operation of Appellant. Given the limited purpose of the supermajority provisions in this instance and the absolute right of the ESOP block to otherwise control Appellant, I cannot find they create the kind of negative control anticipated by 13 C.F.R. § 121.103(a)(3).

I conclude the Record does not contain enough indicia of negative control to support the Area Office's finding of affiliation. Instead, I find there is no material impediment to the ESOP block's ability to control Appellant's operations or to conduct Appellant's business as it chooses. Instead, there is only a well-defined ability to limit the ESOP block's power for three defined extraordinary events (Fact 9). Moreover, I agree with Appellant's assertion that if I were to affirm the Area Office's determination of affiliation through negative control in this instance, I would be creating a *de facto* prohibition upon supermajority voting requirements, regardless of the degree of control they entail. This prohibition would create a chilling effect on a small concern's access to capital. Therefore, I hold the Area Office's determination that LBG has the negative power to control Appellant based upon the supermajority requirements of the Stockholder Agreement, and thus the concerns are affiliates, constituted a clear error of law.

Identity of Interest Affiliation

The Area Office found Appellant and LBG share an identity of interest, and were thus affiliates, based upon LBG's ownership of 49.5 percent of Appellant's stock. While I agree LBG's ownership stake makes it interested in Appellant's success, I cannot agree it means LBG shares an identity of interest with Appellant under 13 C.F.R. § 121.103(f).

The regulation governing economic identity of interest provides:

> Individuals or firms that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships) may be treated as one party with such interests aggregated.

13 C.F.R. § 121.103(f).

There is no evidence that LBG and Appellant share common investments. Moreover, there is no evidence that Appellant is financially dependent upon LBG. Instead, the Record indicates Appellant often competes against LBG and its business relationship with LBG constitutes less than two percent of Appellant's revenue (Fact 8). Therefore, Appellant is not economically dependent upon LBG under 13 C.F.R. § 121.103(f), and thus Appellant and LBG's interests should not be aggregated.

The Area Office also based its identity of interest finding upon LBG's hypothetical divestiture of its interest in Appellant, and the resulting speculative impact on Appellant's financial condition. An identity of interest affiliation, however, must be supported by facts showing the firms' economic interests are aligned. Area offices are not free to find an identity of interest based upon a hypothetical or speculative adverse action not supported by the record. Moreover, Appellant is not a public company and the Stockholders' Agreement (Paragraph 3, *et seq*.) effectively protects Appellant if LBG wants to sell its stock because it grants Appellant the right of first refusal under predetermined conditions.

In consideration of the foregoing, I hold the Area Office's determination of affiliation based upon an identity of interest is not supported by 13 C.F.R. § 121.103(f) or the Record and that the Area Office's analysis of the identity of interest issue is based upon clear errors of law.

Totality of the Circumstances

The Area Office did not find affiliation based upon the totality of the circumstances and thus the matter is not subject to my review. Nevertheless, my view of the Record is that there is insufficient proof to support a finding of affiliation based upon the totality of the circumstances.

## V. Conclusion

For the above reasons, the Area Office's size determination is REVERSED and Appellant's appeal is GRANTED.

This is the final decision of the Small Business Administration. *See* 13 C.F.R. § 134.316(b).

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THOMAS B. PENDER
Administrative Judge